



# **Tax Issues for the New Millennium: Ecommerce and State/Local Sales Tax**

*Presentation to:*  
**California Tax Policy Conference**

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# Presentation Outline

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- ✦ Internet Tax Freedom Act
- ✦ Current Sales and Use Tax System
- ✦ Tax Policy Issues
- ✦ Compliance Cost Burdens
- ✦ Internet Tax Revenue Impacts
- ✦ Conclusions

# Internet Tax Freedom Act

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- ✱ 3-year moratorium on new Internet access taxes or discriminatory taxes on ecommerce
- ✱ Set up Advisory Commission on Electronic Commerce (19 state, federal, and business members) to study taxation of Internet
- ✱ April 2000 deadline for findings and Congressional recommendations
- ✱ Recommendations must apply to all forms of remote commerce including mail order sales

# Current Sales & Use Tax System

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- ✱ Interstate (remote) sellers have no “duty to collect” sales or use tax from consumers unless seller has physical in-state presence (U.S. Supreme Court, *Quill* decision, 1992)
- ✱ Taxable purchases from remote sellers are subject to use tax, but states are not effectively collecting the tax from residents
- ✱ Most services (financial and travel services) are not taxable; many products are exempt (food and drugs)

# Sales Tax Policy Issues

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## ✦ Complexity

Current transaction-based sales taxes are too complex -- used by 7,500 governments in 46 states with different rates, bases, filing and compliance requirements

## ✦ Uniformity

- Imposes the same liability for sales tax on all consumers, but different levels of compliance and enforcement (Main Street vs. remote sales)
- May treat different forms of the same products or services differently (tangible software vs. downloaded digital software).

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# Sales Tax Policy Issues (cont.)

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- ✱ Concern over the long-run growth of the tax base
  - Shift from taxable goods to non-taxable services
  - Increased importance of remote sales
- ✱ Excess compliance burdens -- sales taxes are expensive to administer and costs are borne primarily by retailers (*Quill* case concern)
- ✱ Debate over who will bear the costs of collecting the tax -- government, retailers or consumers
- ✱ State-local fiscal balance & autonomy

# Internet Tax Policy Issues

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- ✦ Large number of new, small sellers exposed to sales tax complexity and high compliance costs
- ✦ Uncertainty of tax status
  - Digital products, access, telecommunications, information content, advertising
  - Nexus for sales or income taxes
- ✦ Anonymous, downloaded digital products
  - Destination-based sales tax requires knowing location of consumers
  - Retailers face significant audit risks
- ✦ Unbundling of taxable and nontaxable sales

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# Ecommerce Articles

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- ★ *The Sky Is Not Falling: Why State and Local Revenues Are Not Currently Significantly Impacted by the Internet*
- ★ *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Retailers*

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# Retailer Compliance Cost Burdens

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- ✦ Estimates of retailer compliance costs based on in-state results from State of Washington Dept. of Revenue study and E&Y calculations for multistate retailers
- ✦ Compliance costs include:
  - point-of-sale costs
  - costs of changing rates and bases
  - filing costs
  - credit card fees
  - costs of making mistakes
  - audit costs (not included in E&Y estimates)

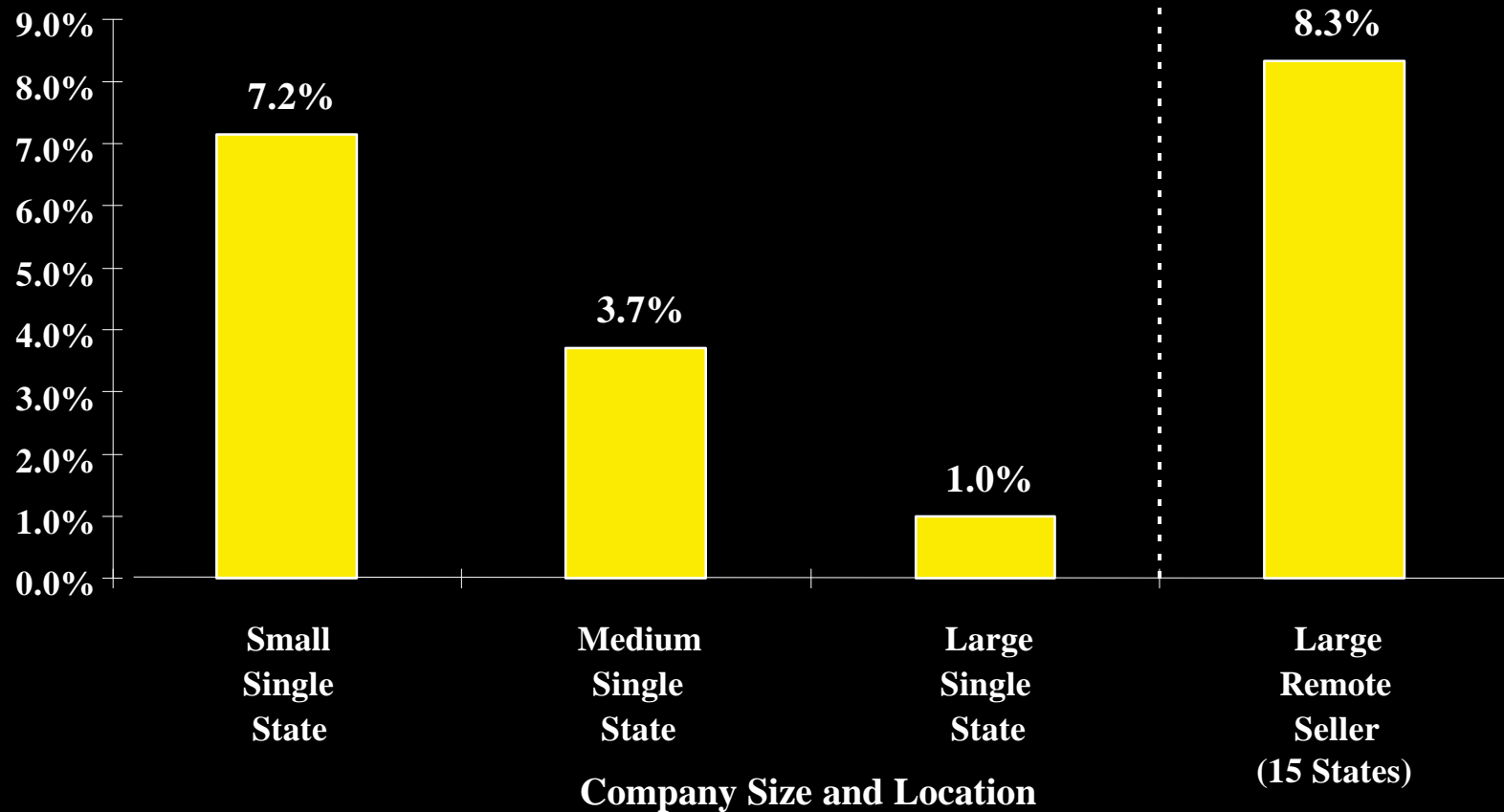
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# Single-State Retailer Compliance Cost Burdens

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- ✦ **Single-state retailers bear high compliance costs**
  - **Small firm (\$250,000 in taxable sales) has very high compliance costs: 7.2% of taxes collected,**
  - **Mid-size firm (\$750,000 of sales) still faces high costs: 3.7% of collections**
  - **Burden drops to 1% of taxes for the large firm with \$10 million of taxable sales**
- ✦ **Retailer compliance cost burdens of 4 to 7% can be compared to state tax agency costs of 1-1.5%**
- ✦ **Place smaller firms at a competitive disadvantage**

# Compliance Costs As a Percent of Sales Taxes Collected



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# Compliance Cost Burdens for Multistate Retailers

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- ✱ Remote sellers with a duty to collect sales taxes in multiple states face significantly higher compliance costs than same-size, in-state sellers
- ✱ A large firm with duty to collect sales taxes in 15 states faces compliance costs equal to 8.3% of taxes collected
- ✱ For retailers selling in all 46 states, compliance costs range from 87% of taxes for the small firm to 14% for the large firm

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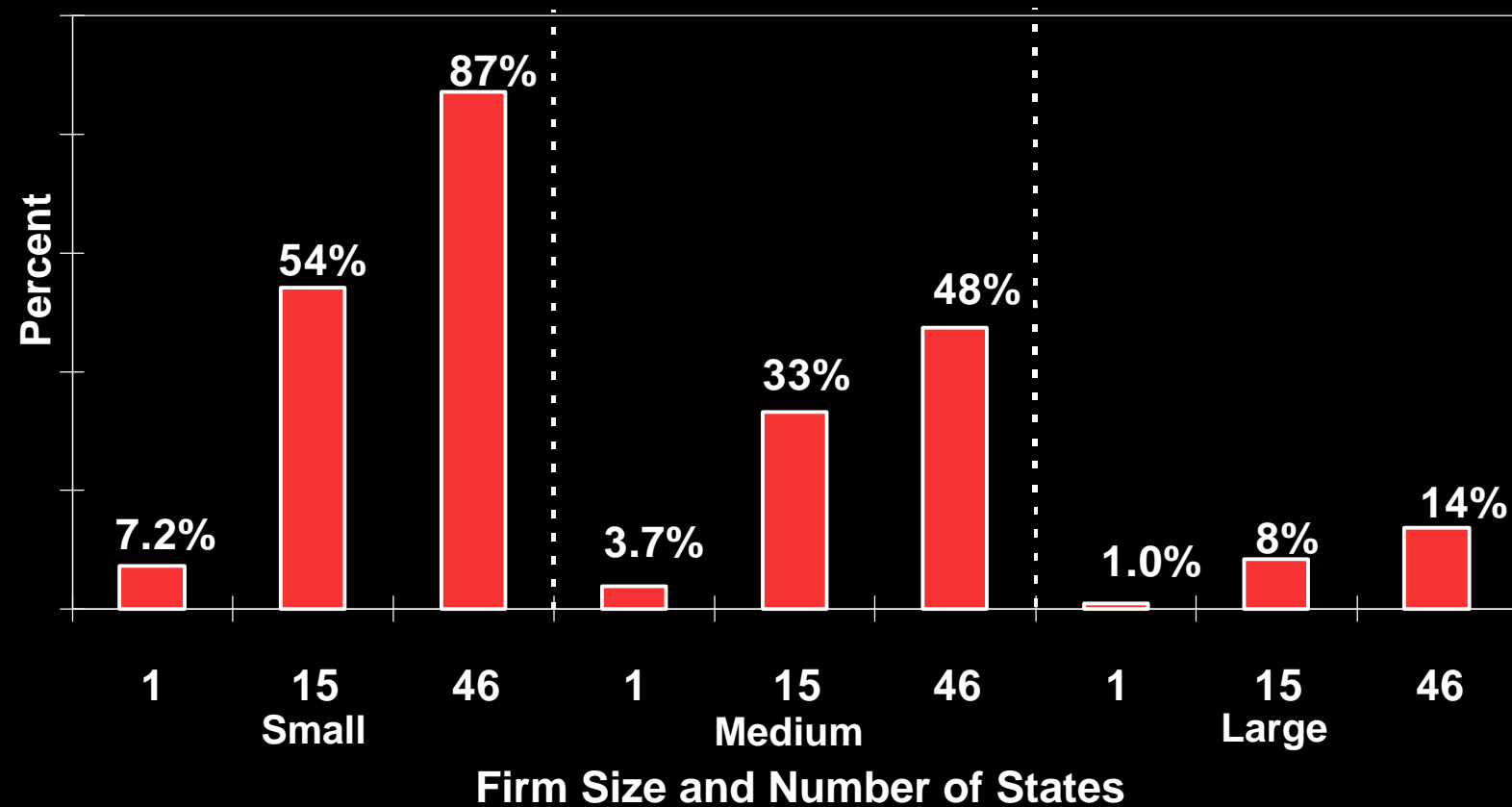
# Compliance Cost Estimating Methodology

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- ✦ **Begin with the in-state estimates from State of Washington report**
- ✦ **Allocate the same total sales for each size firm to 15 or 46 states**
- ✦ **Adjust for filing frequency and combined state-local returns by state**
- ✦ **Adjust costs that vary with no. of states**
- ✦ **Switch to tax rate and filing software when economically justified**

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# Compliance Costs As a Percent of Taxes Collected



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# Compliance Solution Myths

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- ★ *Single state rate solves the problem*

Tax base uniformity is more important than single rate

- ★ *Technology will solve the problem*

Technology will help, but costs may be prohibitive for smaller retailers; digital products cannot be sourced to destination

- ★ *Third-parties have the information*

Credit card companies don't have the information -- future role of cybercash

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# Revenue Impacts: Business-to-Business Internet Sales

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- ✱ 80% of total sales over the Internet
- ✱ Many purchases are tax exempt including sale for resale and manufacturing exemptions
- ✱ Larger businesses in most states have direct pay permits that allow them to pay a self-assessed use tax instead of the sales tax
- ✱ Tax agencies regularly audit their sales and use tax payments



# **Internet Sales Tax “Revenue Crisis” Has Not Yet Materialized**

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- ✱ Only 20% of Internet sale are retail sales to consumers (\$20 billion in 1998)**
- ✱ Only 37% of Internet retail sales to consumers are taxable (\$7.4 billion)**
- ✱ Sales taxes are collected on 11% of taxable retail sales (\$0.8 billion)**
- ✱ 60% of remaining taxable sales (\$4 bil.) substitute for other remote sales -- no new tax loss**

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# Estimates of Ecommerce Sales Tax Impacts, 1998

Steps	Percent of Sales	Amount (millions)
Total Business-to-Consumer Sales	100	20,000
Less: Percent Non-Taxable	63	<u>-12,600</u>
Equals: Taxable Sales	37	7,400
Less: Sales Tax Paid	4	-800
Less: Sales Substituting for Other		
Remote Sales, No Tax Collected	20	<u>-4,000</u>
Equals: Sales, No Tax Collected	13	2,600
Times: Average State and Local Tax Rates		6.5%
Equals: Estimated Sales Tax Loss		\$170

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# **Retail Sales Tax “Revenue Crisis” Has Not Yet Materialized (cont.)**

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- ☀ Internet retail sales tax base of \$2.6 billion represents new untaxed sales -- 13% of Internet consumer sales**
- ☀ Net effect is that the 1998 Internet retail sales tax loss was \$170 million, only 1/10 of 1.0% of \$188 billion in taxes**
- ☀ Stakeholders have time to carefully consider Internet sales tax policy issues**

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# What Can Be Done?

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- ✦ **Current sales tax complexity imposes unsustainably high compliance burdens on small to mid-size multistate retailers**
- ✦ ***Simplification* is the critical first step in reducing compliance costs and resolving the remote sales issue**
- ✦ **There is no quick or easy fix to this problem (see NTA Final Report)**

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# Advisory Commission Remote Sales Tax System Criteria

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- ✦ **Radically simplify the system**
- ✦ **Impose no new taxes on the Internet**
- ✦ **Remove seller compliance cost burdens**
- ✦ **Protect consumer privacy**
- ✦ **Recognize sovereignty of states**
- ✦ **Impose uniform taxes**
- ✦ **Protect interstate and international competitiveness**

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# Conclusions

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- ★ **The solution to the challenges of taxing remote sales will require basic restructuring of the sales tax system**
- ★ **Fortunately, Congress, state and local governments and retail businesses have time to simplify the sales tax system, reduce compliance costs and develop a more uniform tax for the 21st Century**

# The Property Tax in the New Millennium

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# Themes

- The evolution of the property tax in the U.S.
- The challenge from school finance
- Tax limitations
- Alternatives for local finance
- The onset of direct democracy
- The persistence of a basic property tax



# A Capsule History

- It started as an “in rem” tax on specific property (cattle, land, improvements) and moved to an ad valorem tax
- In the late 19th century, there were “uniformity clauses” intended to include financial capital--but these died for theoretical and administrative reasons
- Over this century, the property tax moved from a state tax to a local tax

# The Emergence of the “Ideal Local Tax”

- Economists and political scientists became enamored with the idea of local communities tailoring their property tax to meet the desires of their residents.
- New England town hall meets Adam Smith
- But two developments conspired to defeat this vision: school finance litigation and property tax limitations

# School Finance Litigation

- The property tax has been challenged in virtually every state on state constitutional grounds--education has a different status than other local goods
- Even New Hampshire, the poster child for the ideal tax, has seen recent fiscal turmoil--they even flirted with a personal income tax!

# Why School Finance is Important

- Political support for the property tax is much more likely if it funds education, not general county services
- Using other taxes to fund education leads to cuts in property taxation (examples: Wisconsin, Michigan in the 1990s)
- Falling political support feeds into property tax limitation movements

# Property Tax Limitations

- Most states have some limitations--first wave during Great Depression, second wave during the 1970s.
- Lack of educational linkages will only reinforce them--one theory even links Prop 13 to Serrano litigation and educational finance.

# Diversity of Property Tax Limits

- Rate limitations are common
- Limits on growth of total assessed value statewide or by other units
- Proposition 13 style limits on assessed value on individual properties
- These can pose equity issues, But we need a benchmark for comparison

# Alternatives For Local Finance

- More use of local sales tax
- Increased use of fees and charges
- Transfer fees on properties
- Increased use of benefit assessment charges and development fees with California and other fast-growing states leading the way
- A less transparent fiscal system?

# Onset of Direct Democracy

- If the property tax can no longer be carried by its educational role and the tax system becomes less transparent, taxpayers may want more specific input into the uses of property-related revenue
- Proposition 218 in California starts this trend with more direct voter participation in decisions on taxes, assessments, and fees



# Is This a Healthy Development?

- Is more direct democracy just a return to New England town meeting?
- But, in California, this occurs without any discretion on the basic property tax rate
- We are “unbundling” public services--this raises important economic efficiency issues, are local services interdependent?

# What About Taxes on Business?

- Separate rates for business has its dangers:
  - While more revenue can be raised, competitive pressures can lead to lower business rates
  - Classification has no natural ending point
  - Equal rates might be the best long run solution
- While “intangibles” may be a tempting target, the century started by removing financial assets from the tax base

# Persistence of Basic Property Tax

- Too many virtues to disappear
  - Proven revenue raiser
  - Taxing land is efficient
  - Sales and income tax are more vulnerable to global trends
- Through the educational connection and intergovernmental transfers, the property tax will largely be a state tax once again